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SENSITIVE
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Classified By: Economic Officer Daniel Daley pursuant to 1.4(c)(d)

¶11. (C) Summary. According to the World Bank and IMF, massive overruns in the Malawian government's agricultural input subsidy program are creating in a budget shortfall, which the local World Bank Country Manager estimates may reach as high as USD 70 million, with no clear prospects for closing the gap. Although the GOM insists the cost of these overruns will not affect the current budget, the result, at best will be that much of this cost will be deferred until next year. Distribution of fertilizer as political pork, and possible large-scale corruption, appear to be the drivers behind the last-minute ballooning of the program appears. Generally praised for its handling of the economy since taking power, the Mutharika administration risks serious damage to its legacy and credibility as it recklessly pursues a renewed electoral mandate. End summary.

Budget Buster Let Loose

¶12. (SBU) Malawi has enjoyed several years of strong growth, assisted by the improved macroeconomic policies and fiscal discipline of the Mutharika administration. The macro forecast for the coming year, however, is turning increasingly grim. Ref. A reported on the significant impact on the GOM budget of the government's signature agricultural input subsidy program. Although the current budget included large increases to cover higher market prices of fertilizer, actual increases in prices at the time of purchase were higher still, leading to a budget gap estimated by the IMF in the fall to be USD 40 million. At that time donors came together to help close this gap with supplemental funding, such as the Exogenous Shock Facility (ESF) provided by the IMF (Ref. B). Major additional funding was promised by the World Bank (USD 10 million), DfID (GBP 5 million), and the EU (EUR 9 million). The contributions, however, were provided in return for a stated GOM commitment to limit the subsidy program to 170 thousand metric tons of fertilizer.

¶13. (C) It is now known, however, the GOM has massively expanded the subsidy program with local purchases of fertilizer, bringing the total to almost 240 thousand metric tons - almost a 40 percent increase. Since this additional fertilizer was purchased locally, the GOM paid the higher market prices that were prevailing when the fertilizer was originally imported, rather than today's lower prices on the international market. The result is that the GOM, according

to the World Bank, is now facing a projected budget gap of USD 70 million, based upon the additional expenditures alone.

The gap may well be larger, however, because the government's action in increasing fertilizer purchases calls into question the rationale for treating the earlier budget shortfall as an 'exogenous shock.' As a result, donors that had committed to providing additional budget support may be forced to reevaluate that support. The World Bank Country Manager indicated to Emboffs that Bank procedures will definitely require such a reevaluation, and the disbursement of the previously promised additional resources could not be assured.

"There is no budget deficit" - The GOM's Shell Game

¶4. (C) Minister of Finance Goodall Gondwe insists that the increased fertilizer purchases will have no impact on the current budget. While this is technically true -- the fertilizer purchases have been made by a parastatal company, not by the GOM itself -- most expect that the GOM will ultimately be left holding the bag. Gondwe says that financing for the expanded purchases will come from commercial banks. Part of this financing will be obtained through a buy-back scheme - Gondwe stated that the GOM was already in negotiations with Standard Bank on such a scheme. The scheme would entail the parastatal selling unused stocks of fertilizer to the bank, with the GOM providing a commitment to buy it back for next year's program. The budgetary cost of this year's surplus purchases would thereby be transferred to the next fiscal year. Gondwe acknowledges that the GOM will pay a premium, since the high cost of this fertilizer over current market prices would thereby be carried over to next year's budget. One additional problem with this plan is that it presupposes that there is unused

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fertilizer available to sell. World Bank sources report, however, that as much as 200 thousand metric tons have already been distributed from the government's central storage facility.

¶5. (C) How the remaining funding can be found remains unclear. Gondwe's insistence that the funding will not come from the GOM budget rules out international donors, who cannot be expected to provide financing to a parastatal company. In any event, it is unlikely that donors would be forthcoming with yet more resources even for the GOM, especially in view of the GOM's failure to adhere to its earlier commitment on the size of the subsidy program, and in light of the global financial crisis. The GOM may have some additional unprogramed resources available from the fuel stabilization fund (which has been growing since the drop in global oil prices), but estimates put this total at less than USD 30 million by the end of Malawi's fiscal year in June. Additionally, much of this money has already been tentatively earmarked to finance much-needed expansion in Malawi's electricity generation capacity.

¶6. (SBU) One likely solution to the financing gap will include additional borrowing. As it is unclear if the banking system holds the necessary money to lend, this would ultimately need to be backed by the Reserve Bank of Malawi (RBM), with a consequent massive increase in the money supply. Such a course would erase all of the administrations hard-earned gains in reducing its debt burden and could likely lead to significant crowding out in the capital market as well as a jump in inflation.

Was it Even Necessary?

¶7. (U) The justification for the fertilizer subsidy has always been that it ensures Malawi's food security by improving the maize harvests. Malawi's recent good harvests have won the country and the program international praise.

Undoubtedly, fertilizer has improved yields. The timing of the application of fertilizer is important, however, and the recent new purchases came when the optimal time for application had already passed. Even so, Malawi can probably expect to have another good harvest this year due to good rains and increased cultivation.

18. (C) The decision to expand the subsidy program purchases was taken at the Ministry of Agriculture without consulting the MoF. (Note: The President himself is also the Minister of Agriculture. End note.) With elections scheduled for May 2009, it was always expected that maintaining fiscal discipline would be a challenge for the government. With food security a chronic issue in Malawi, the agricultural subsidy and the resulting good harvests, have been hugely popular. The GOM appears to have chosen political expediency over fiscal responsibility.

Comment

19. (C) With relatively large sums involved, Malawi's input subsidy program has always been susceptible to corruption and political favoritism. Charges of corruption and political diversion of resources have always dogged the program, but it now appears that the GOM is aggressively milking the program for partisan ends. The Mutharika administration has enjoyed the general support of the international community because of its sound macroeconomic and fiscal policies, and to a lesser extent its achievements in improving Malawi's food security. While another good harvest is likely to maintain its reputation for feeding the nation, the handling of this year's subsidy program will cause serious damage to its image as a responsible and upright steward of the country's economic stability.

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